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Variation margin relief sparks swaps pricing disputes

Banks divided over whether to price trades using current CSAs or theoretical new agreements

Firms disagree over which collateral agreements to use when pricing trades

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Confusion around how to price derivatives trades with counterparties still using collateral agreements that are not compliant with new margin rules is leading to disputes, according to dealers.

Regulators in Canada, the European Union, Japan and the US have **temporarily allowed banks** to continue trading non-cleared derivatives with smaller counterparties using old collateral agreements, known as credit support annexes (CSAs), that have not been updated with the new variation margin requirements.

But since the rules came into effect on March 1, dealers say there is uncertainty about which CSA should be used to price the trade: the existing agreement or a theoretical new contract that is regulatory compliant and will cover the majority of the trade's life.

“Let's say it's March 15, and you sign a CSA with a counterparty. Which trades does it cover: only the ones after March 15, or also the ones between March 1 and March 15? That's the big question that is out there currently,” says a collateral management source at one European bank, who says this issue has caused numerous pricing disputes in the market.

In order to trade after March 1, financial counterparties with CSAs need to either amend their existing documents to comply with the margin rules, or sign a new CSA that covers new trades. In-scope counterparties without CSAs must sign one before being able to trade. The rules include a number of specific CSA requirements, including the elimination of minimum posting thresholds and a shorter timeframe for collateral transfers.

The collateral manager says his bank’s view is that all trades executed after March 1 should be priced off a regulatory compliant CSA, even if one is not yet in place.

“At the end of the day, the regulation is live. It says every trade after March 1 has to be margined in a regulatory compliant way. Even if you sign a document on March 15, you still have to cover all trades after March 1,” he says.

Given that US regulators are only applying forbearance until the end of September, a senior trader at one US insurance company says new trades on old agreements will quickly be moved to regulatory compliant CSAs and should be priced accordingly.

“I think that’s clear. If you look at the relief that was given, the expectation is you'd move those trades by September under the new CSAs. So if the dealers aren't pricing [a new trade] assuming the terms of a new CSA, or the revised CSA, then the pricing is wrong,” he says.

That is easier said than done. If a bank has yet to finish, or even start, repapering negotiations with a counterparty, it can't know for sure what terms will be in the final CSA.

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Regulatory source at a UK bank

"If I trade with you under a CSA and I don't know the terms of the CSA yet … how can I price it correctly? It may be cash, cash and gilts, or even multi-currency," says a regulatory source at one UK bank in London.

This puts the bank at risk, as it could price a trade assuming terms that do not end up in the final document. The regulatory source says that in order to mitigate this, his bank is pricing in worse terms than it believes will be contained in the final document.

"I have to price worse than what the terms might turn out to be, but that's the price clients will have to pay if they want to trade during the exemption period," he says.

Not everyone agrees. Some banks say that for a party that is amending its existing CSA to become regulatory compliant, the bank should price off the current document. Once the CSA is updated, the parties will then settle the resulting difference in present values, if it is material.

Other banks are taking a more practical approach. The European bank's collateral manager says that while he believes it's right to price off a regulatory compliant CSA, his firm is pricing new trades based on existing CSAs as it intends the terms of the regulatory compliant CSAs to be as close to current documents as possible.

A senior trader at one global bank is taking the same approach: "By and large, we understand most people aren't really changing the parameters in the CSA that are strongly commercial, such as eligible collateral. So we don't see the pricing issues as a challenge; they can be resolved. There might be some edge cases we might look at. For example, where there is no CSA and we are creating a new one, that needs to be taken into account in the pricing approach."

Operational problems

Operational issues at banks are also complicating matters. The backlog of CSAs yet to be uploaded means there will be situations where a client has signed a new CSA but it is not yet live in a bank's collateral system. A survey by the International Swaps and Derivatives Association found that as of the week ending March 3, banks had repapered 40.72% of clients, but only 10.45% of documents had been uploaded to banks' reference data systems.

A risk manager at a US bank in New York says that in this situation his firm is still pricing trades off a regulatory compliant CSA. "It could be the case that we signed on February 27 and the effective date is March 1, but it might take until March 5 before it's live operationally. In that case, the new collateral assumptions should still be effective, so we should be pricing with whatever the effective CSA date is," he says.

Conversely, the European bank's collateral manager points out that if an existing client has signed a new CSA to take over from its old collateral agreement from March 1, the client would be expecting two separate margin calls – one for the portfolio covered by the old CSA and another from the new CSA – but would only receive one until the new agreement is uploaded to the system.

He says this is creating a big operational headache: "You need to manually agree with a bank's operations desk to margin them together," he says.

"We will focus on the clients that have actually traded with us so that we can internally prioritise these clients. But it should only be a problem for one or two days," he adds.

The US bank's risk manager also says it is struggling to meet the US requirement to transfer variation margin the day after a trade is executed – known as T+1 – for clients who repapered at the last minute.

"Right now, we are not operationally doing T+1 with some counterparties because they signed so late and we are still trying to get them live. We are still trading under new CSA terms, but operationally we are moving collateral under old CSA terms [that are not T+1]," he says.

Bankers had estimated that around 85% of the buy side trade on a T+2 basis, and that it would take a significant shift to move to T+1 – especially when posting bonds as margin, which take time to settle. As a result, some buy-side firms are said to be posting cash as it settles immediately.

Other operational issues are also causing problems with the buy side. Some foreign exchange funds are finding that closing out non-deliverable forward trades that were executed before March 1 now requires variation margin, which is leading to unbalanced transfers of collateral.

"Common sense tells you that the position is closed and there shouldn't be any contingent variation going back and forth, but we had some conversations with banks where they hadn't got complete clarity on it yet. One would hope common sense prevails. But if you interpret the rules literally, you could cause some people problems," says James Binny, head of currency for Europe, the Middle East and Africa at State Street Global Advisors in London.